CLS's

WEEKLY 3

What You Need to Know About the Markets

JULY 2, 2019

1 New CLS Investment Themes: Be Active. Be Resilient. Be Innovative.

2 Top 10 Investor Questions

3 Politics and investment returns don't mix.

Month in Review

The S&P 500 Index rallied more than 18% to start off 2019, notching its best first half in more than 20 years. Those gains primed Wall Street to start the second half of the year with a bang following a big first half.

June was a mirror image of a tough May. Stocks erased all of May's losses and were positive every single week! June was the second-best month for global stocks in the past three years, exceeded only by the surge in January of this year.

June is generally one of the weakest months for equity market returns — hence the old adage "Sell in May and go away." But not this June — the S&P 500 jumped nearly 8% for the month, marking the best June performance since 1955.

Markets recovered from May's decline largely after the Federal Reserve indicated it would continue to assess the economic situation and be accommodative if need be. While the Fed has indicated a willingness to cut rates, the futures market that predicts Fed rate movements is giving an interest-rate cut before year-end a 100% chance. We'll see. Hopes of a resolution to the ongoing trade conflict also helped support stocks, particularly toward the end of the month.

CLS portfolios performed well last month. While international markets slightly lagged domestic returns, value stocks began to show signs of life. Value stocks outperformed growth for the first time this year. Sector positioning in energy, health care, and materials also contributed positively to performance. Diversifying asset classes, such as fixed income, alternatives, and commodities, while underperforming equities, still contributed positively to returns.

While June returns were strong, we do expect volatility in the summer months as low trading volumes and unpredictable trade rhetoric can create market jitters. However, with volatility comes opportunity.

Rusty Vanneman, CFA, CMT

President, Chief Investment Officer

Rusty Vanneman is responsible for leading CLS's Portfolio Management Team and overseeing all investment operations at CLS, including investment philosophy, process, positioning, and performance. Mr. Vanneman is also responsible for internal and external communications regarding market environment and current investment strategies. He is part of the management team for several of CLS's proprietary mutual funds. In 2018, Mr. Vanneman took on the role of President of CLS, in addition to his position as CIO.

Mr. Vanneman joined CLS in September 2012 as Chief Investment Officer. Previously, he served as Chief Investment Officer and Portfolio Manager at Kobren Insight Management (KIM) in the greater Boston area. His 11-year tenure at KIM included a 5-year span during which the firm was owned by E*TRADE Financial and he served as the Senior Market Strategist for E*TRADE Capital. Prior to working at KIM, he was a Senior Analyst at Fidelity Management and Research (FMR Co) in Boston. He was also a Managing Analyst at Thomson Financial.

Mr. Vanneman received a Bachelor of Science degree in Management from Babson College where he graduated with high distinction. He has held the Chartered Financial Analyst® (CFA) designation since 1994, and is a member of the CFA Institute. He has also been a Chartered Market Technician (CMT) since 1999, and is a member of the Market Technician's Association (MTA). In addition, Mr. Vanneman authored the book "Higher Calling: A Guide to Helping Investors Achieve Their Goals." He was named one of the Top 10 Portfolio Managers to Watch by Money Management Executive in 2017.*

Did you know? Rusty had a brief stint as a cowboy near the town of Valentine in Cherry County, Nebraska.

The overall global stock market rose more than 6% in June and is up by more than 16% for the year. The U.S. stock market rose 7% in June and is up by nearly 19% for the year. Smaller companies gained just more than 7%, and larger companies gained just under 7%. Both are up more than 18% year-to-date.

Developed international equity markets gained just under 6% in June and remain higher by more than 14% so far this year. Emerging markets returned nearly the same as developed, rising nearly 6%, and are higher by just more than 10% this year.

The bond market was up just more than 1% in June and is now higher by almost 6% for the year. The 10-year U.S. Treasury yield ended June at 2%, briefly dipping below 2%, while the three-month U.S. Treasury yield ended the month at 2.1%. It is not common to see short-term interest rates higher than longer-term rates, which is what we're seeing now. This is deemed an "inverted" yield curve, and it typically suggests lower economic growth is ahead but not necessarily immediate.

Real assets rebounded some last month. Commodities gained nearly 4% in June and are up by just more than 10% year-to-date, while global real estate investment trusts (REITs) recovered just under 1% and are higher by a little more than 14% so far this year.

Market Performance *(as of 6/30/2019)*

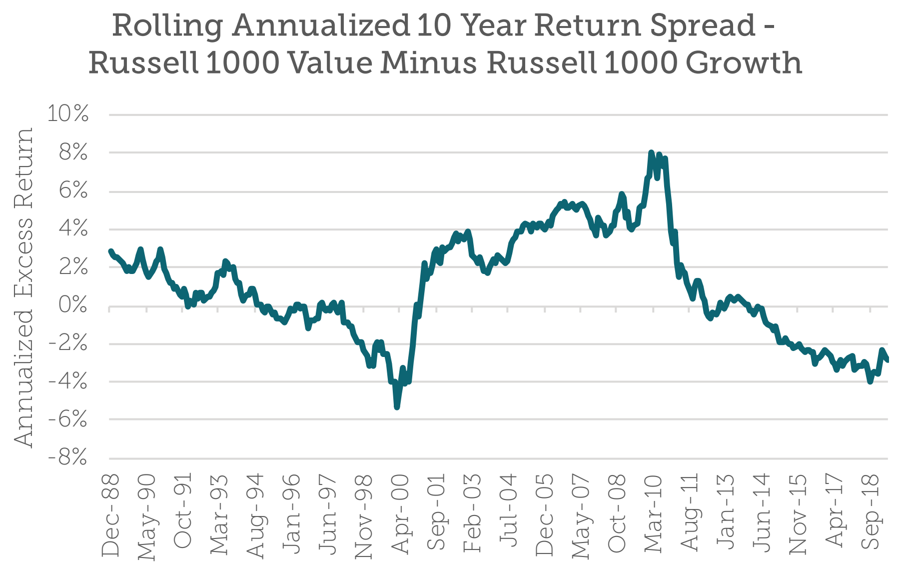
Fixed Income	10-YEAR	5-YEAR	3-YEAR	1-YEAR	YTD	QTD	JUNE
Cash Equivalent[1]	+0.45%	+0.84%	+1.36%	+2.26%	+1.20%	+0.61%	+0.18%
U.S. Investment Grade Bonds[2]	+3.90%	+2.95%	+2.31%	+7.87%	+6.11%	+3.08%	+1.26%
Equities	**10-YEAR**	**5-YEAR**	**3-YEAR**	**1-YEAR**	**YTD**	**QTD**	**JUNE**
Global Equity Market[3]	+10.34%	+6.19%	+11.60%	+5.64%	+16.10%	+3.58%	+6.43%
Total U.S. Market[4]	+14.76%	+10.34%	+14.13%	+9.51%	+18.88%	+4.20%	+7.00%
Domestic Large-Cap Equity[5]	+14.52%	+10.96%	+14.66%	+10.82%	+18.09%	+4.33%	+6.93%
Domestic Small-Cap Equity[6]	+14.11%	+6.73%	+11.05%	-1.50%	+18.05%	+2.21%	+7.11%
International Equity[7]	+6.87%	+2.37%	+9.35%	+1.32%	+13.37%	+2.87%	+5.82%
Developed International Equity[8]	+7.00%	+2.17%	+8.98%	+0.83%	+14.37%	+3.53%	+5.80%
Emerging Market Equity[9]	+6.47%	+3.05%	+10.72%	+3.15%	+10.44%	+0.94%	+5.90%
Diversifiers	**10-YEAR**	**5-YEAR**	**3-YEAR**	**1-YEAR**	**YTD**	**QTD**	**JUNE**
Diversified Alternatives[10]	+3.94%	+0.25%	+1.53%	+1.03%	+3.81%	+0.83%	+1.16%
Commodity[11]	-3.74%	-9.15%	-2.18%	-6.75%	+5.06%	-1.19%	+2.69%

[1]Morningstar Cash Index [2]Bloomberg Barclays Capital U.S. Aggregate Bond Index [3]Morningstar GblMkt Large-Mid Index [4]Morningstar U.S. Market Index [5]Morningstar U.S. Large Cap Index [6]Morningstar U.S. Small Cap Index [7]Morningstar Gbl xU.S. Large-Mid Index [8]Morningstar DM xUS Large-Mid Index [9]Morningstar EM Large-Mid Index [10]Morningstar Diversd Alt Index [11]Bloomberg Commodity Index.

1 CLS's New Investment Themes

We are excited to announce some changes to the CLS Investment Themes. These themes weave a common thread between all portfolios at CLS Investments, despite different mandates, Risk Budgets, and portfolio management teams. They reflect how we build portfolios, how we select securities, our views on the economy, and how we're positioning portfolios based on those views. The themes also capture our expectations for the future and the investment opportunities we believe will present themselves.

Our CLS Investment Themes are created by the CLS Investment Team, but they are ultimately approved by the CLS Investment Committee. These are the first changes in several years.



Source: Morningstar Direct. Data from January 1979 through May 2019. Based on comparison of the Russell 1000 Value Total Return Index vs. the Russell 1000 Growth Total Return Index.

Be Active

Our first theme is a repackaging of two previous themes, and we are retaining the name: "Be Active." Essentially, this theme reflects our belief that investors need to be active in managing their portfolios. Being active means a few things, the simplest being not buying the market blindly by passively purchasing an index to match its return (minus fees, of course). Instead, investors should take advantage of opportunities the market presents because expected risks and returns are always evolving. For instance, value-oriented stocks are currently underperforming growth stocks, as they have for several years. By some measures, it is the longest stretch of underperformance ever. This looks and feels like the market of the late 1990s, just before value dramatically and significantly outperformed.

Be Active also captures our belief that since we primarily manage Risk Budgeted portfolios, we place more emphasis on security selection. In other words, since we manage to specific risk targets, we can't outperform the market by buying the market. Instead, we buy securities that differ from the market and other managers, such as smart beta ETFs and actively managed ETFs.

Be Resilient

Our second theme, Be Resilient, is based on two concerns that we have about the economy and markets. Regarding the economy, we believe that after the longest economic expansion on record, we are now "late cycle." The portfolio implications of this include rotating our sector exposure to more non-cyclical (less sensitive to the economy) sectors, such as consumer staples and healthcare.

In addition, the bond market – while still an important component of multi-asset portfolios to help manage portfolio risk – isn't as attractive considering how low interest rates are. Thus, we need to be creative in how we diversify equity risk and manage portfolio risk. This means we will use alternative investments and strategies, such as funds that specialize in merger arbitrage and real assets, including commodities and real estate investment trusts (REITs). REITs typically perform better when inflation expectations rise, which they inevitably will, causing headwinds for traditional stocks and bonds.

Be Innovative

The third CLS Investment Theme is Be Innovative. While we think the coming year(s) could see below-average economic growth, we are incredibly positive about the future given all the innovative and life-enhancing advances taking place in so many industries, including healthcare, financials, clean energy, and many others.

2 10 Quick Answers for Long-Term Investors

Recently, I was on a podcast where I answered 10 questions in 10 minutes. It was a fun format, so I thought I'd try it out here with quick answers to the top questions I've received lately from advisors.

1. What do we expect from the stock market for the remainder of 2019?

We don't think the last half of the year is likely to cause any major changes to long-term investment portfolios. We do expect two things. First, we expect to see more price volatility, meaning more frequent price movements, both upward and downward. This is not atypical of the market, which is inherently emotional and messy. But this volatility will likely provide investment opportunities.

Market volatility is a bit irrational, which is helpful for investors to remember. Keep in mind that market volatility is more than two times higher than corporate earnings volatility! That doesn't make much sense. Meanwhile, corporate earnings volatility is three times higher than the overall economy, as defined by GDP. That's right – the stock market is about seven times more volatile than the economy itself. Volatility is destabilizing, but it also creates opportunities.

Second, we expect the stock market to generate even more gains on top of above-average gains already achieved this year. There are many reasons for this. First, the market typically trends upward, and this is especially true during the third year of the presidential cycle. In addition, the last three months of the year are generally the strongest, so this period will likely incur further gains. Some sentiment indicators also suggest that investors are still quite negative on the market, which typically means above-average returns for the next six months!

All things considered, I would say there's a greater chance for a "melt-up," in which the market races sharply higher, than a "meltdown," which many investors seem to fear.

2. What do we expect from the bond market for the remainder of 2019?

We expect interest rates to rise. The decline in yields this year has been remarkable. Growth data has slipped, but the bond market's move feels like an overreaction, especially since some inflation data has steadily crept higher.

At a recent presentation I attended at MIT in Cambridge, Massachusetts, a former member of the European Central Bank discussed various sets of economic data. While his political side would not allow him to directly recommend a course of action for the Fed, he did show that economic growth is now above "potential" GDP, which suggests the "output gap" has closed and the market could be overheating. He also showed similar data regarding the unemployment rate. Both data series suggest inflationary pressures may start to appear – a trend that should not have been expected over the last 10 years due to a large output gap from the Great Recession. This would suggest higher interest rates are more likely than not.

In addition, investor sentiment for bonds is incredibly bullish. This sets the stage for reversals in market direction because, if everybody is bullish, who is left to buy? In fact, even though the bond market generates positive returns 85% of the time over trailing 12-month periods, it typically generates negative returns following bullish sentiment extremes.

3. Are we nervous about a recession?

Did you know that it typically takes three to six months to identify if an economy is in a recession? Every time you see a chart matching up recessions with market behavior, remember that the recession was identified well after the fact and not in real time.

With that being said, one indicator has pretty successfully predicted recessions. Since 1980, it has provided three signals, and each time, a recession occurred a few months later. This indicator is an inverted yield curve, which occurs when long-term bond interest rates are lower than short-term bond yields. This is not typical in the bond market and suggests lower economic growth. The yield curve inverted in May, and we are watching it closely. It is a significant reason we developed the Be Resilient investment theme.

4. What will the Fed do next with short-term interest rates?

The market expects the Fed to cut rates. It probably will, but it's not such a slam-dunk decision in my opinion. The economy is not that bad. There are some budding inflationary pressures, and interest rates are already low. My current expectation is that the Fed

2 10 Quick Answers for Long-Term Investors (Cont.)

will not make any moves this year. Of course, I reserve the right to change my mind as the data and facts change!

5. What do you think of Europe's economic situation?

Europe is still a mess. Remember the European crisis a few years ago? Well, it really hasn't gone away; the market narratives have simply moved elsewhere. Rising nationalism/ populism, the potential for a hard Brexit, and an unsustainable euro currency are adding to the region's woes. Since we are global investors at CLS, we do have exposure to Europe in our portfolios, but we are underweight relative to the overall global market. Still, despite all these issues, there are values to take advantage of. And, if prices sink further, we'll buy more. There are multinationals in Europe doing the same work as multinationals in the U.S., but they trade at far lower valuations. That means they have higher expected returns.

6. How do you expect the trade discussions to be resolved?

Like most market participants, I expect market volatility to increase as a result of the public rhetoric. But I also expect a positive conclusion. It's simply in the best interests of all parties involved. However, unlike many market participants, I think there's a chance (perhaps 10-20%) of a very positive conclusion.

7. What do think of Twitter's impact?

Thanks to President Trump, tweets from the Oval Office have become a real deal. Supposedly, even researchers at the Fed (the best and the brightest, who have the best data and tools) now monitor the President's Twitter account and try to quantify the impact. However, the impact of presidential tweets is a short-term game, and it is not necessary for long-term investors to monitor them or make shifts in their portfolios accordingly. For long-term investors, it's noise.

8. What is the future of Bitcoin and other cryptocurrencies?

Bitcoin has had an amazing run this year, returning to levels last seen in early 2018. At CLS, we are excited for cryptocurrency ETFs to be created. We see it as a budding asset class segment; if used in proper sizing, such as very small portfolio weights given the accompanying volatility, it could be a useful tool in managing overall portfolio risk. However, the asset class could use more seasoning, so more data and metrics are desired to assess potential value and risk characteristics.

9. Will the dollar rebound?

The U.S. dollar has had a great run, but prices have broken down recently. For the first time in many quarters, they have dropped below the key 200-day moving average, which many investors follow and act upon. This would suggest that the dollar will continue to get weaker as currencies tend to trend in the same direction. Furthermore, if the Fed reduces short-term interest rates, more pressure will be placed on the currency.

All else being equal, a weaker dollar would mean strong relative performance for international securities and real assets, such as commodities.

10. What is your best investment idea?

Emerging market value stocks! We discuss this often, but emerging market value remains our highest conviction view. It's the one asset class segment that appears to offer above-average return expectations relative to long-term averages over the next five to 10 years. As mentioned last month in this space, emerging market value stocks offer essentially the same growth (if not slightly more) than the S&P 500 index, but their valuations are 50%-67% lower. Now that's an asset class on sale!

3 Red or Blue Investment Plan?

By Jeovany Zelaya, Client Portfolio Manager

The debates have started for the Democratic candidates. Brace yourself for 17 months of political banter, television ads, and arguments from pundits and family members on your social media platforms.

But it's not only about politics for some. There are investors who believe that their favored political party or presidential candidate will positively shape their portfolio returns. However, research has shown that there is no persuasive relationship between the political party in power and stock returns.

Many cite research by Pedro Santa-Clara and Rossen Valkanov (2003) and Lubos Pastor and Pietro Veronesi (2017) who studied the topic of presidential politics and stock returns. These researchers, in sum, reviewed a data series from 1927 to 2015 and found the average stock market return under a Democratic president is 10.7% per year and only -0.2% under a Republican president. Given the strong returns so far with the current Republican administration, the Republican numbers would increase, but not significantly. The researchers also found there was less stock market risk while a Democrat was president.

These results might seem counterintuitive. The Republican Party is known to be more business friendly and tax averse, while the Democratic Party is known to advocate redistributing wealth and stronger social insurance for individuals.

Robert Arnott, Bradford Cornell, and Vitali Kalesnik (2017) also found that the two biggest U.S. market crashes (1929 and 2008) happened while a Republican was in office. Black Tuesday occurred while the "Great Engineer," Herbert Hoover, was in office. When he was president from 1929-1933, the stock market had about a -30% annualized return. Ouch! At least we still have the Hoover Dam.

The CAPE (cyclically adjusted price-to-earnings) ratio, which is a measure of how expensive or cheap an investment is, was hovering around 30 on October 29, 1929. When stock prices came crashing down during this era, so did the CAPE ratio, eventually reaching a 6. These were bargain prices! It seemed like the only direction this ratio (and stock prices) could go was up, and indeed, they did go up. The next president elected was a Democrat, Franklin D. Roosevelt. During his first term in office, the stock market had annualized returns of about 26%, and the CAPE shot back to about 21.

However, this is just one instance, and the sample sizes for the studies referenced above are too small. It's true they include more than 85 years of data, but that's only 23 administrations. That's simply not enough to conclude whether these results will continue into the future.

In addition, Arnott, et al., found that when similar studies were conducted outside the U.S., they returned mixed results. The authors concluded that the U.S. was an outlier and not the norm when it came to one political party showing a sort of relationship with stock market returns.

Basing your investment decisions on a specific party is sort of like placing your bets on butter production. As researcher David Leinweber found in 1997, the single best predictor of S&P 500 index returns is butter production in Bangladesh.

When it comes to picking the red party or the blue, stick to the issues our elected representatives really have some control over. To guide your investments, pick a specific investment plan, and focus on your personal financial goals.

To learn more about CLS's objective and reliable approach to investing, please visit clsinvest.com or give us a call.

Have a safe and happy Fourth of July!

Parties Designated as Having Left and Right Orientations by Country

Country	Left Party	Right Party
Australia	Labor Party	Liberal Party
Canada	Liberal Party	Conservative Party
France	Socialist Party	Union for the Popular Movement
Germany	Social Democratic Party	Christian Democratic Union
United Kingdom	Labor Party	Conservative Party

Source: Research Affiliates, LLC.

Average Stock Market Return Differences for Periods of Power of Left and Right Political Parties, Jan 1950–Feb 2017 (Jan 1988–Feb 2017, France and Germany)

Country	Left Party	Right Party	Difference
Australia	2.74%	8.84%	-6.10%
Canada	7.13%	3.12%	4.01%
France	9.18%	4.93%	4.25%
Germany	1.87%	8.96%	-7.09%
United Kingdom	5.97%	7.86%	-1.89%
Average	5.38%	6.74%	-1.36%

Source: Research Affiliates, LLC, using data from Global Financial Data (GFD). Note: The stock market return is in local currency. We use the S&P/ASX Index in Australia, Canada S&P/TSX Index in Canada, CAC 40 Index in France, DAX 30 Index in Germany, and FTSE All Shares in the United Kingdom. For periods prior to the launch of these indices, in some cases GFD uses alternative data sources to estimate the local market return. For all countries, we use the three-month Treasury bill as the risk-free rate of return.

Thank You

As always, a sincere thank you for reading. If you have any questions or feedback, please let me know.

Stay balanced and stay the course.

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The Morningstar Global Market Large-Mid Index is an index that measures the performance of the global market's equity markets targeting the top 90% of stocks by market capitalization. The Morningstar U.S. Market Index is an index that measures the performance of U.S. securities and targets 97% market capitalization coverage of the investable universe. It is a diversified broad market index. The Morningstar U.S. Large Cap Index is an index that measures the performance of U.S. large-cap stocks. These stocks represent the largest 70% capitalization of the investable universe. The Morningstar U.S. Small Cap Index is an index that measures the performance of U.S. small-cap stocks. These stocks fall between the 90th and 97th percentile in market capitalization of the investable universe. In aggregate, the Small Cap Index represents 7% of the investable universe. Morningstar Global ex U.S. Large-Mid Index is an index that measures the performance of Global Markets (ex-U.S.) equity markets targeting the top 90% of stocks by market capitalization. The Morningstar DM ex U.S. Large-Mid Index is an index that measures the performance of developed markets ex-U.S. equity markets targeting the top 90% of stocks by market capitalization. The Morningstar EM Large-Mid Index is an index that measures the performance of emerging markets targeting the top 90% of stocks by market capitalization. The Barclay's Capital U.S. Aggregate Bond® Index measures the performance of the total United States investment-grade bond market. The Morningstar Cash Index is an index that measures the performance of a Treasury Bill with six to eight weeks until maturity in the U.S. market. The Bloomberg Commodity Index is made up of exchange-traded futures on physical commodities and represents commodities that are weighted to account for economic significant and market liquidity. This index provides investors with a means of understanding the performance of commodity futures markets and serves as a benchmark for investment performance of commodities as an asset class. The volatility of the indexes may be materially different from the individual performance attained by a specific investor. In addition, portfolio holdings of investors may differ significantly from the securities that comprise the indexes. You cannot invest directly in an index.

The S&P 500 Index is an unmanaged index of 500-large capitalization companies. This index is widely used by professional investors as a performance benchmark for large-cap stocks.

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**CLS Investment, LLC ("CLS") Chief Investment Officer, Rusty Vanneman, CFA, CMT, was selected as a "Top 10 Fund Managers to Watch" in 2017 by Money Management Executive. Money Management Executive is an unbiased, third-party publication covering the asset management industry. Money Management Executive chose the list of managers to watch by screening Morningstar data from funds with a single manager, ranked as having the best three-year annualized returns in their respective categories. The list of managers was published March 27, 2017. Money Management Executive is not affiliated with CLS. Ratings and awards may not be representative of any one client's experience and are not indicative of CLS's future performance.*

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